

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



BOARD OF EQUALIZATION
REVENUE ESTIMATE

December 18, 2002 Public Hearing to adopt proposed Regulation
1671.1; Proposed Staff Revisions

Issue

On September 11, 2002, the Board made substantial revisions to proposed Regulation 1671.1, *Rebates and Incentives*. The Board further instructed staff to republish Regulation 1671.1 for adoption on December 18, 2002.

The proposed revisions to Regulation 1671.1 significantly affect the tax treatment of manufacturing coupons, rebates and incentives. Section (c) (2) states:

A manufacturer may issue coupons that customers can provide to retailers at the time of purchasing the manufacturer's product, thus entitling a customer to a certain amount or percentage off the advertised selling price. Amounts paid by a manufacturer to a retailer for the redemption of a coupon used for the purchase of the manufacturer's product are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer.

However, in the absence of a coupon that must be redeemed by the customer, revenue received by the retailer from the manufacturer (such as in the form of "Buy Downs", "Promotions", "Discounts" and other price reductions) in exchange for the retailer reducing the sales price of the product would not be included in the retailer's gross receipts.

At the present time, proposed Regulation 1671.1 does not impose tax on rebates or incentives paid by a vehicle manufacturer to a vehicle dealer when the dealer makes a retail sale of a vehicle at a discount to a customer that does not furnish the dealer with a manufacturer's coupon. This is a change from the current tax treatment of rebates or other incentives on vehicle sales. Staff has recommended to the board that the proposed regulation be amended to provide that vehicle rebates and incentives remain subject to tax whether or not a physical coupon or other indicia is provided by the customer to the dealer.

Background, Methodology, and Assumptions

Introduction

In gathering information for this revenue estimate, we found that the manufacturer of the product does not always provide the redemption value of the rebate. For example, Verizon and AT&T Wireless cellular service providers routinely offer promotional rebates on handsets manufactured by companies such as Nokia, Kyocera, and Ericsson. We also found that MSN and Prodigy Internet service providers have offered instant rebates on the purchase of personal computers in exchange for signing up for their service for up to three years. Consequently, the term “manufacturing rebates” does not fully describe the various promotional rebate offers currently in the market. These transactions are essentially third-party discounts or rebates to the customers purchasing the product from a retailer, whether the manufacturer or a third party such as a service provider provides the redemption value. We know that there is a significant amount of these third party promotional rebates that exist in the market. However, we don’t know the exact number of different products that have promotional rebate offers included in their sale price, nor do we know their total retail value.

Cigarette and Tobacco Products

In a February 13, 2001 memorandum to Ramon Hirsig, titled *Buy-Down Rebates*, we estimated that the annual manufacturers’ rebates on cigarettes amounted to \$146.7 million, (\$11.6 million in State and local tax revenues) or 3% of taxable sales. This estimate was based on information gathered by the Sales and Use Tax Department (SUTD) in contact with tobacco manufacturers by requesting information on their buy-down rebate programs.

Drug Stores, Grocers, and Mass Merchandiser Rebates

The California Grocers Association (CGA) also provided us with a general product list of items on which rebates might be offered, but it did not include any information on the volume of the rebates. They also provided information from two of its members indicating that they received rebates on detergents, paper products, carbonated soft drinks and alcoholic beverages in addition to rebates on tobacco products.

We have found little information to confirm the information provided by the CGA on rebates for products other than cigarettes. Soft drink manufacturers have indicated that they either never offered such rebates or no longer do so. Manufacturers of paper products and detergents indicated that they do not offer such rebates. An analysis of recent audits of grocery stores revealed that in 48 of the 395 audits analyzed, cigarette rebates were an issue. Rebates on products other than cigarettes were found in only one audit. Those rebates pertained to soft drinks and the amount was minimal.

Nonetheless, the CGA received its information from two of its large supermarket chain members. The members felt that the products listed indicate that tobacco products are not the leaders with respect to the buy-down rebate revenue they have received. However, since we cannot verify this information, we can only assume that a substantial amount of buy-down rebates exist.

In addition to the information obtained from CGA, we found that a number of other products sold by mass merchandise chains included some form of third party discount. For example, a recent Sacramento Bee newspaper article reported that lagging CD music sales have prompted at

Revenue Estimate

least one record label company (Murder Inc./Island Def Jam Records) to offer a \$2.00 per disc rebate to retailers. We also found a number of articles on the Internet reporting that Hewlett Packard, among other manufacturers, offers instant rebates on PCs, printers, and other electronic products. Recently, we found a rebate offer from Bed, Bath and Beyond advertising an instant manufacturer's rebate on a comforter. Another form of a manufacturer rebate used by mass merchandisers and other retailers is called a scan-back. A scan-back is a manufacturer rebate given to a retailer based on the number of units the retailer sells during a promotion period. In some instances, scan-backs may qualify as a buy-down rebate when other conditions are met.

To estimate the amount of buy-down, scan-back, and instant rebates on products other than cigarettes, we first calculated the annual taxable sales for retailers most likely to use buy-down rebates as promotional incentives. We assumed that drug stores, grocers, and mass merchandise stores were more likely to use various forms of rebate promotions through the many manufacturers, and the numerous product lines engaged in business with these types of retailers. Taxable sales for the three industry groups noted above amounted to just over \$30.5 billion in calendar year 2001. If we assume that at least 1% of their taxable sales are from various forms of rebate promotions, as opposed to the 3% of taxable sales attributable to the buy-down rebate program on cigarette and tobacco products, as noted above, then taxable sales on these buy-down rebates amount to \$305.4 million annually, as shown below:

<u>Industry Group</u>	<u>Taxable Sales</u> (in millions)
Grocers	\$124.5
Mass Merchandisers	125.6
<u>Drug Stores</u>	<u>55.3</u>
Total	<u>\$305.4</u>

The revenue impact on state and local sales and use tax amounted to \$24.2 million, as shown below:

	<u>Revenue</u>
State Loss (5.00%)	\$15.3 Million
Local Loss (2.25%)	\$ 6.9 Million
<u>Special District Loss (0.67%)</u>	<u>\$ 2.0 Million</u>
Total Revenue Loss	\$24.2 Million

Cellular Phone Rebates

The cellular phone industry represents a market sector that routinely offers third party rebates. According to representatives from Verizon and AT&T Wireless, cell phone rebates are offered on approximately 60% of the total phones sold in the US, with an average rebate of \$50 per phone. According to the Cellular Telecommunications and Internet Association (CTIA), total cell phone sales are estimated at 50 million in the US for 2002. California makes up approximately 12% of the total US market, or about six million cell phones per year. The taxable sales on these rebates amount to \$180 million (6 million x .60 x \$50). The revenue loss in state and local sales and use tax for exempting these sales amount to \$14.3 million annually, as shown below:

Revenue

Revenue Estimate

State Loss (5.00%)	\$ 9.0 Million
Local Loss (2.25%)	\$ 4.1 Million
Special District Loss (0.67%)	\$ 1.2 Million
<u>Total Revenue Loss</u>	<u>\$14.3 Million</u>

Automobile Manufacturing Rebates

According to an article in the February 15, 2001 issue of the CIO Magazine, US automobile manufacturing rebates in 2000 amounted to \$24 billion. These rebates continued to be offered in 2001 and 2002. California makes up approximately 12.4% of the total US market, or about \$2.976 billion in taxable sales. The revenue loss in state and local sales and use tax for exempting these sales amount to \$236 million annually, as shown below:

	Revenue
State Loss (5.00%)	\$ 149.0 Million
Local Loss (2.25%)	\$ 67.0 Million
Special District Loss (0.67%)	\$ 20.0 Million
<u>Total Revenue Loss</u>	<u>\$ 236.0 Million</u>

Revenue Summary

The impact from the proposed revisions to Regulation 1671.1 would result in a revenue loss of state and local sales and use tax in the amount of \$286.1 million annually, as shown below:

	Total Sales Tax @ 7.92%
Cigarette Rebates/ Chapter 9	\$ 11.6 Million
Drug, Grocer, and Mass Merchandise Stores	\$ 24.2 Million
Cell Phones	\$ 14.3 Million
Automobile Rebates	\$ 236.0 Million
<u>Revenue Loss</u>	<u>\$ 286.1 Million</u>

The impact from the staff proposal that the Board amend the currently published Regulation 1671.1 language to provide that vehicle rebates and incentives remain subject to tax would decrease the revenue loss by \$236 million and would result in a revenue loss to state and local sales and use tax in the amount of

	Total Sales Tax @ 7.92%
Cigarette Rebates/ Chapter 9	\$ 11.6 Million
Drug, Grocer, and Mass Merchandise Stores	\$ 24.2 Million
Cell Phones	\$ 14.3 Million
<u>Revenue Loss (Net of Automobile Rebates)</u>	<u>\$ 50.1 Million</u>

In addition to the on-going annual revenue loss enumerated above, the proposed Regulation would allow the provisions to apply to petitions for redetermination and claims for refund filed but not yet final as of August 1, 2002. There are a number of such claims on cigarette rebates that amount to \$2.9 million in tax. This would be a one-time revenue loss.

Preparation

Bill Benson, Jr., Research and Statistics Section, Administration Department prepared this revenue estimate. Mr. Dave Hayes, Manager, Research and Statistics Section, Administration Department and Ms. Charlotte Paliani, Program Planning Manager, Sales and Use Tax Department reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of December 9, 2002

\\S7000\DATA\GROUP\BTC\BTC TOPICS - 2001\02.5 Grocers Rebates (Reg 1671.1)\Revised Regulation\1671.1 REVEST (11-15-02).doc